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ABSTRACT

Background information regarding the draft of "Audits of Educational Institutions," released by the Accounting Principles Board of AICPA, is presented. Sixteen proposed changes are identified to alert and assist the individual business officer in working with his public accountant or state auditor to assure reasonable interpretations appropriate in the individual situation. Audit Guide proposals are grouped as follows: investments and endowments, primary financial statements, current revenues and expenditures, plant, and other changes. The investments and endowments category covers investment performance, carrying value of investments, funds held in trust by others, and endowment income stabilization reserve. Primary financial statement recommendations deal with reporting formats for balance sheets, statements of changes in fund balances, and statement of current funds expenditures and resources utilized. Current revenues and expenditures include student fees specifically assessed for plant financing, provision for encumbrances, services and facilities provided by religious orders, and revenue and expenditure categories. Provision is made for debt service on the educational plant and for depreciation. Other changes deal with loan fund matching grants, annuity and life income funds, disclosure of pledges, agency funds, and Accounting Principles Board opinions. (LBH)

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RECENT DEVELOPMENTS IMPACTING FINANCIAL REPORTS OF COLLEGES AND UNIVERSITIES

A background for review of the draft of *Audits of Educational Institutions*,
to be released shortly by the Accounting Principles Board of AICPA.

By Robert B. Gilmore

A consensus may be at hand between college and university business officers and CPAs regarding accounting principles and reporting standards for published financial reports of colleges and universities. Most of the proposed changes are those evolving from the work of the AICPA Committee on College and University Accounting and Auditing, in that Committee's development of an industry guide, *Audits of Educational Institutions*. Our university business officers have been fully represented in discussions through the NACUBO Manual Revision and Accounting Principles Committees. Preparatory to exposure, the draft of the industry guide has been submitted to the Accounting Principles Board of AICPA. Proposed changes which would modify existing principles and reporting standards may best be evaluated by comparison with the 1968 edition of *College and University Business Administration*, commonly known as the "Manual."

At the present time some of the proposals have been endorsed by the NACUBO Accounting Principles Committee while others have not yet had final action by that committee. While the AICPA Audit Guide is in process, NACUBO will also be at work on revisions of the 1968 Manual through the loose-leaf *Administrative Service* which, prior to publication, will involve broad exposure of the proposals for accounting changes to officials of individual institutions and will assure that revisions will be responsive to institutional needs. It now seems likely that the CPA's industry guide and our Manual revision will be in general agreement, a situation much to be desired.

It is the personal recommendation of the writer that the Audit Guide, taken in its entirety, deserves the support of college and university business officers. The requirements seem logical and applicable for the majority of institutions. Following committee approval, the draft has been submitted for pre-exposure and informal review within the Accounting Principles Board (APB) and the Committee on Auditing Procedure (CAP). There is, however, a possibility that subsequent modifications may overturn the work of the AICPA committee. If the final publication should be found to be unacceptable, higher education

representatives will need to address the new problems in a constructive and vigorous fashion.

It therefore appears timely to identify the proposed changes, sixteen in number, and offer a rationale for industry support of these proposals. It should be understood that the Audit Guide is intended for general but authoritative guidance to the individual CPA in his conduct of his audit and forming his opinion regarding the financial statements. The auditor "in the field" retains broad discretion in matters of materiality and adequacy of disclosure, inasmuch as the opinion is his responsibility. The commentary in this paper is intended to alert and assist the individual business officer in working with his public accountant (or state auditor) to assure reasonable interpretations appropriate in the individual situation.

Audit Guide proposals which differ from the 1968 Manual are grouped for purposes of this presentation as follows:

Groupings	Sections
Investments and Endowments	4
Primary Financial Statements	1
Current Revenues and Expenditures	4
Plant	2
Other Changes	5

INVESTMENTS AND ENDOWMENTS

Investment Performance

Disclosure of investment performance of portfolios held in endowment or other funds is called for, ordinarily by notes to financial statements or appropriate supplementary schedules or exhibits. This is a modest and feasible step



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toward fair disclosure, moving somewhat in the direction of investment trust or mutual fund reporting. When a substantial portion of a portfolio is pooled and unitized, performance of one pool unit or share can be reported in terms of investment income, realized gains/losses, and change in market and carrying (book) values.

The Audit Guide deals with accounting for investment income on the basis of conventional fiduciary concepts of ordinary income. Amounts withdrawn from quasi-endowment representing accumulated portfolio realized gains, on a total return concept, are required to be handled as transfers, not as revenue. This treatment is in accordance with current interpretations of statute and common law in most states. However, the Audit Guide does in a tacit way acknowledge that, in some states, legal counsel for an institution may interpret the statute to manage endowment and similar funds on the basis of total return under specified terms and conditions. Nonetheless, in such situations the expendable yield over and above ordinary investment income is, according to the Guide, to be accounted for as a transfer rather than as part of revenue, i.e. endowment income. However, where the application of total return is essentially a formula method of withdrawal of principal from quasi-endowment funds, as is presently the more common approach, the Audit Guide is considered to be on solid ground and states the rationale with clarity.

Carrying Value of Investments

Activity of AICPA committees, other than the College and University Accounting and Auditing Committee, has resulted in some spill-over of commercial problems of balance sheet valuation of equity securities held for investment or for control. A sensible proposal appears in the current Audit Guide draft, giving preference to reporting investments at cost (or fair value at date of gift), but recognizing the alternative basis of current market or fair value, provided all investments are so accounted for. Market fluctuations would be handled in a manner similar to realized gains and losses. Although the foregoing plan is now a firm and coordinated proposal, further APB internal activity may yet generate broad rulings as to equity securities alone which, if applied literally to colleges and universities, would produce inconsistent and therefore unacceptable results. Should this occur, strong and effective counter-proposals by higher education will be urgently required. Endowment funds and funds subject to life income or annuity are accounting entities which hold bonds, real property and other holdings in addition to equity securities. Accordingly, such funds should be a specific exception in any ruling which deals with equity securities alone.

Funds Held in Trust by Others

Ordinarily funds held in trust by others should not be included in the financial statements. However, if an institu-

tion has enforceable rights or claims, such assets and equity may be reflected in the financial statements. This is a modification of the position expressed in the 1968 Manual.

Endowment Income Stabilization Reserve

The Audit Guide stresses several respects in which the endowment stabilization provision, as a withhold from pooled income, subverts a fair disclosure when the amounts are material. The reader of the financial statements is unable to determine the amount of unrestricted endowment income received or earned during the current fiscal year; an undisclosed portion of the income stabilization reserve is unrestricted, whereas the entire amount of the reserve is ordinarily carried as a restricted current fund equity on the balance sheet. The Guide does not condone the foregoing practice. It is expected that no further additions would be made to reserves created in the manner described, and the existing reserve balance would be restored to the respective funds entitled thereto. In the event precise information is not available for such a reallocation, reasonable estimates should be used. This approach removes one of the two alternates which were recognized in the Manual.

PRIMARY FINANCIAL STATEMENTS

Commercial organizations utilize three primary financial statements: the Balance Sheet (Financial Position), the Statement of Income and Retained Earnings (Results of Operations), and a statement summarizing changes in financial position. Colleges and universities have traditionally followed a similar pattern with a Balance Sheet, a Statement of Changes in Funds Balances, and a Statement of Current Fund Revenues, Expenditures and Transfers.

Throughout the period of activity of the AICPA Committee on College and University Accounting and Auditing, there has been continuous study and discussion within the committee and with NACUBO regarding the nature of college financial statements. At the risk of over-simplification, the question has been whether the college or university financial statements are intended to present net income or not. If so, many accounting principles and practices of commercial enterprises, such as inclusion of depreciation in operating costs, must be considered applicable or some rational basis found to explain why college net income differs from commercial. If college statements do not purport to present net income, statement formats now widely used are likely to be misunderstood by presenting excess of current fund revenues over expenditures (or the reverse) on the bottom line of what appears to be a statement of operations and resembles a statement of net income.

The essential premise adopted by the Audit Guide committee is that service rather than profits is the objective of

an educational institution. Therefore, the accounting and reporting for such institutions deal with resources received and used rather than the determination of net income. In addition, it was held that financial statements for all colleges and universities, large and small, simple or complex, should follow a single conceptual framework.

Financial Reporting Format

Accordingly, the Audit Guide will recommend a single set of primary financial statements for colleges and universities, consisting of:

Balance Sheet
Statement of Changes in Fund Balances
Statement of Current Funds Expenditures
and Resources Utilized

The Statement of Changes in Fund Balances to be illustrated in the Guide is columnar in form but without a total column. The column headings across the top, reading from left to right would be: Current Funds: Unrestricted, Restricted; Loan Funds; Endowment and Similar Funds; Annuity and Life Income Funds; Plant Funds (combined into a single column). A total column would not be precluded, provided proper care is taken to avoid the misnaming of totals or the duplicating of gross changes.

This important statement would contain three specified sections in order to describe changes in resources:

Revenues and other additions
Total
Expenditures and other deductions
Total
Transfers among funds
Total
Net Increase (decrease) for the year
Fund balances at beginning of year
Fund balances at end of year

A variation in format but not in principle is provided in the event unrestricted gifts are managed or administered separately from other unrestricted resources. In this case, the current fund columns would appear as follows:

Current Fund			
Unrestricted			Restricted
General	Gifts	Total	

It should be noted that the total amount of unrestricted gifts received during the year will be reported in a single figure, opposite a caption *Gifts* in the *Additions* section, under Current Funds Unrestricted. This is the case whether or not a separate gifts column is shown.

Illustrative financial statements contained in the Audit Guide represent a strong pronouncement which may well lead to greater uniformity in college and university financial reporting. The accounting principles enunciated in the Guide, including the changes from the Manual discussed in this paper, appear to this writer to warrant a full and fair trial in the field of higher education. If experience leads to general acceptance in the industry, significant benefits on a national basis will be the result. These benefits will hopefully include a wider public understanding of the economics of higher education, through more clear and meaningful annual reports. There is great diversity among institutions as to their means of financing and styles of management. These conditions may inhibit or delay general acceptance of the proposed changes. Experience in the field may lead to further changes in basic thinking or accounting responses. However, to the extent the underlying concepts are solid and sound, acceptance is assured.

CURRENT REVENUES AND EXPENDITURES

Student Fees Specifically Assessed for Plant Financing

When student fees are applied to the financing of plant facilities, it is necessary to ascertain whether (a) the action is administrative or discretionary with the governing board, or (b) there are binding, external restrictions which confine the use of the fee proceeds for plant purposes. Examples of the latter would be the terms of a bond issue legislation, or the publicly stated rationale for a special fee assessment, which thereby becomes a firm obligation of the institution. The Guide will state that fees of type (a) should be reported as revenue, and application to plant shown as a transfer. Fees of type (b) would continue to be considered (as provided in the 1968 Manual) as additions to unexpended plant funds, on the basis that the funds are unavailable for current purposes.

Provision for Encumbrances

In some state and local jurisdictions, appropriated public funds are made available on the basis of encumbrance accounting procedures. Some institutions in such systems are accustomed to treat the issuance of purchase orders as expenditures for accounting purposes. This practice was countenanced in the 1968 Manual as a modified accrual basis. The Audit Guide will adhere closely to conventional accrual accounting concepts, which recognize a liability only for goods and services received as of the balance sheet date. Outstanding purchase orders would not be recognized as liabilities or as expenditures of the current fiscal period; however, such amounts may properly be recognized as an allocated portion of the fund balance and/or disclosure by footnote. Experience of some public institutions has demonstrated that state appropriated funds will

not lapse, provided the university or community college presents valid evidence in support of commitments (e.g. purchase orders) and creates a reserve or allocation for commitments. The position taken in the Audit Guide may nevertheless cause problems which will need to be worked out with the auditors, particularly for state and community colleges.

Services and Facilities Provided by Religious Orders

Services evidenced by remittance from the educational entity to the religious order, and the return of such remittance as a gift, should be reported as current expenditures and as gifts received, and usually separately identified in the financial statements. Facilities made available to the educational entity, and related indebtedness, are required to be disclosed in the financial statements.

Revenue and Expenditure Categories

The AICPA Committee is prepared to follow whatever categories of revenue and expenditure the industry puts forward as its recommendation, or those now specified in the Manual. Illustrative statements are expected to differ from the Manual in several respects.

There has been a favorable reception given to published recommendations for classifying revenue by source (tuition, government appropriations, project sponsorship, endowment income, gifts received, etc.) and expenditures by function (instruction, research, public service, libraries, student aid, student services, plant operation and maintenance, etc.). A revenue caption for student aid would not be used inasmuch as such revenues would be included by source, such as gifts or endowment income.

Two limited modifications of revenue and expenditure groupings accepted by NACUBO for use in the Audit Guide are (1) to drop the grouping of *educational and general* from statements of revenues or expenditures, and (2) to provide a sub-total prior to auxiliary activities in presenting revenues or expenditures.

There seems to be intrinsic merit in separating these internally self-supporting activities from the remainder of the institution's programs. The term *auxiliary activities* is intended to combine all of the following: Sales and services of educational departments; organized activities related to educational departments, and auxiliary enterprises.

PLANT

Provision for Debt Service on Educational Plant

The 1968 Manual treated as transfers any usage of current funds for debt service of *educational plant*, whether or not mandatory. Provisions for debt retirement, interest, and

renewal and replacements reserves, required by the terms of the borrowing, are referred to as mandatory debt service. The Audit Guide will recognize that such debt service may be specifically provided for from other sources, for example, by legislative appropriations restricted to the plant purposes. In such cases, the incoming funds and the expenditures appear in the plant fund. The Audit Guide will provide for the situation in which the debt service lacks a specific source other than current revenues, and is therefore considered an encumbrance upon current operating funds of the institution. In this event, the mandatory debt service is treated in the Guide as a current funds expenditure.

Depreciation

Without re-opening the historical question of depreciation charges to operations, a new option is proposed in the Guide for the institution wishing to recognize in the financial statements the expiration of cost of capital assets. In the statement of changes in plant fund balances, the investment in plant may be reduced, in which case the balance sheet asset account will reflect the residual unexpired costs.

OTHER CHANGES

Loan Fund Matching Grants

The Guide provides for the accounting treatment for matching loan grant funds, where the source of such matching is current revenues. In view of the mandatory nature of the matching, as in the case of the National Defense Student Loan grants, the amount would be reported as a current fund expenditure, rather than as a transfer. This requirement does not apply when the institution elects to provide the matching funds by transfer from other sources, such as quasi-endowments, unexpended gifts for student aid, or other loan funds. The Manual contemplates a transfer, on the basis that the funds will be converted to loans receivable.

Annuity and Life Income Funds

The Audit Guide provides a method of accounting for annuities which would present a liability equal to the present value of annuities payable. The difference between the liability and the assets of the annuity funds would be shown as the fund balance. This actuarial method is preferred, according to the Audit Guide, and should be used unless the historical (Manual) method would produce substantially the same result. The actuarial method appears to be somewhat more laborious than that described in the Manual. On the other hand, since annuity liabilities might exceed the fund assets, a balance sheet disclosure on the actuarial basis may well be warranted. The current draft has been revised to recognize the new forms of charitable remainder trust included in the 1969 Revenue Act.

Disclosure of Pledges

The Audit Guide will place significantly greater emphasis upon statement disclosure of gift pledges receivable, as compared to the 1968 Manual. The Guide will favor balance sheet reporting of the estimated net realizable value of pledges. The amount to be recorded would be reduced from the face-value of pledges to recognize (1) discounting long-term pledges to present value, and (2) allowance for pledges estimated to be uncollectible. These adjustments, together with the fact that some pledges are of indeterminate value or maturity, may greatly reduce or eliminate the value to be reflected in the balance sheet. In any case, footnote disclosure of material pledges, and the time periods involved, seems to be a reasonable requirement.

The college business officer should not hesitate to bring to the attention of his public accountant a donor relation-

ship which would be harmed by a request for written confirmation. In such cases the auditor may be able to satisfy himself by other means as to the validity of the receivable.

Accounting Principles Board Opinions

Recent and also future APB opinions requiring specific disclosure in financial reports, such as those relating to accounting changes, employee benefit plans and long-term leases, are considered applicable to colleges and universities.

Agency Funds

The Audit Guide indicates preference for a separate agency fund group for balance sheet disclosure. Only if such amounts are not material in amount would inclusion among current fund assets and liabilities be considered an acceptable option.

A CROSS-INDEX TO TOPICAL REFERENCES IN 1968 MANUAL

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As indicated earlier, future APB pronouncements must be monitored with great care by higher education to preclude the possibility of inappropriate literal application to colleges and universities of rulings based upon the commercial environment. It is hoped that the APB and the AICPA will recognize as imperative the need for a continuing specific, deliberate, and responsible dialogue with the

higher education industry before final determinations are made with respect to college and university accounting principles and reporting standards.

By the same token, college and university business officers, many of whom are members of the AICPA, have the obligation to stay abreast of current developments and maintain a proper regard for standards of fair and adequate financial disclosures.

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